

KIRKLAND GOVERNANCE WATCH

April 8, 2011

SEC Proposes Compensation Committee Independence and Related Rules

Considerable Deference Given to Exchanges

The proposed rules would establish independence requirements for both the compensation committee of a listed issuer's board of directors and for any compensation consultants retained by such compensation committee.

On March 30, 2011, the SEC proposed rules to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").¹ The proposed rules would establish independence requirements for both the compensation committee of a listed issuer's board of directors and for any compensation consultants retained by such compensation committee. The proposed rules would also supplement the existing proxy disclosure requirements regarding compensation committees.

Independence Requirements of Compensation Committee and their Compensation Consultants

The proposed rules would only apply to issuers with listed equity, and would not apply to controlled companies or issuers with only listed debt securities. The compensation committee independence requirements also would not apply to companies in bankruptcy and certain other categories of issuers. The national securities exchanges (e.g., NYSE and Nasdaq) are tasked with implementing the proposed rules through their listing standards and would be free to exempt other classes of issuers.

Independence of Compensation Committee Members. The proposed rules would require that a compensation committee consist entirely of independent directors. The standards which will determine independence would be set by the exchanges but would be required to consider: (1) the director's current sources of compensation (without consideration of any former sources) and (2) whether the director is affiliated with the issuer. Unlike the independence standards for audit committee members, which statutorily define certain required independence thresholds, the exchanges do not need to treat either of these factors as being preclusive of independence.

The SEC notes that "[t]he exchanges may determine that, even though affiliated directors are not allowed to serve on audit committees, such a blanket prohibition would be inappropriate for compensation committees, and certain affiliates, such as representatives of significant shareholders, should be permitted to serve." This flexibility is a welcome departure from the strict formulation of the audit committee rules as directors affiliated with significant investors (such as private funds) are often motivated to rigorously oversee executive compensation and have a more demanding pay-for-performance approach.

The proposed rules also would not require that a listed issuer actually have a compensation committee, although NYSE listing requirements and other SEC and Internal Revenue Code requirements often may compel this result in practice.

Use and Independence of Compensation Consultants. The proposed rules require that compensation committees have the authority and the funding to engage a compensation consultant, legal counsel and other advisor, for which the compensation committee is directly responsible. The rules do not, however, require a compensation committee to actually engage such an advisor, or, once engaged, to follow their advice. The rules also do not prohibit management from separately engaging a compensation consultant, legal counsel or other advisor. Listed issuers should consider whether their current compensation committee charters will need to be amended to specifically allow the engagement and payment of a compensation consultant.

If a compensation committee chooses to engage a compensation consultant, legal counsel or other advisor, the proposed rules require the committee to first consider the independence of such advisor. After such consideration, however, the compensation committee may still choose to retain an advisor which is not independent. In addition to any factors identified by the exchanges in their listing standards, the rules require the compensation committee to consider the following five independence factors: (1) other services provided by the advisor to the issuer; (2) the relative importance of revenue from the issuer to the advisor; (3) the advisor's internal policies for avoiding conflicts of interest; (4) any other relationships between the advisor and a member of the compensation committee; and (5) any stock of the issuer owned by the advisor.

Compensation Committee Disclosure Requirements

Discussion of Conflicts of Interest. The proposed rules also would amend Item 407(e)(3) of Regulation S-K, to require additional disclosure about whether the work of a compensation consultant has raised any "conflict of interest" (which is defined by referencing the list of five independence factors discussed above) and, if so, the nature of the conflict and how the conflict is being addressed.

Because these disclosure requirements will apply to all issuers filing proxy statements, they will apply even to controlled companies. As a result, even though a controlled company would not be required to consider a compensation consultant's independence when engaging them, such an issuer would still need to evaluate the consultant's independence for purposes of their proxy disclosure.

Revised Trigger for Compensation Consultant Disclosure. The proposed rules also broaden the trigger for requiring disclosures pursuant to Item 407(e)(3)(iii), to "whether compensation committee retained or obtained the advice of a compensation consultant" from whether compensation consultants played "any role." The phrase "obtained the advice" is defined broadly to include any situation where the compensation committee or management has requested or received advice from a compensation consultant, regardless of whether a formal engagement or client relationship exists and whether or not fees are paid.

The SEC also proposes to eliminate the existing exception from the requirement to identify compensation consultants and describe their engagements for cases in which a consultant's role is limited to consulting on a broad-based plan or providing non-customized benchmark compensation information. As a result, issuers may be required to disclose even broad based industry surveys obtained by the compensation committee.

The existing requirements regarding disclosure of compensation consultant fees would also be broadened to correspond to the expanded trigger of "retaining or obtaining the advice of a compensation consultant" rather than being strictly tied to formal "engagement" of a compensation consultant. No disclosure regarding fees would, however, be required for cases in which a consultant's role is limited to consulting on a broad-based plan or providing non-customized benchmark compensation information.

Timing

The SEC is seeking comment from interested persons on a number of topics until April 29, 2011, including whether the exchanges should be required to consider additional independence factors. The Dodd-Frank Act requires the SEC to enact final rules with respect to the foregoing by July 16, 2011. Under the SEC's proposed rules, the exchanges would then need to have their final rules approved by the SEC no later than one year after publication of final rules by the SEC. As a result, it could be as late as July 2012 before the compensation committee and compensation consultant independence requirements take effect. The compensation committee disclosure requirements would take effect as soon as the SEC publishes final rules.

¹ A copy of the proposed rules is available at: <http://www.sec.gov/rules/proposed/2011/33-9199.pdf>.

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